Sheryl (Sherry) Herauf
Director
Federal Regulatory Relations

1275 Pennsylvania Avenue, N.W., Suite 400
Washington, D.C. 20004
(202) 383-6424

PACIFIC TELESIS
Group-Washington

DOCKET FILE COPY ORIGINAL

RECEIVED

SEP 10 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

September 10, 1996

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-150, Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*

On behalf of *Pacific Telesis Group*, please find enclosed an original and six copies of its *"Reply Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Sherry Herauf (JB)

Enclosures

No. of Copies rec'd 0+5
List ABCDE

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RECEIVED

SEP 10 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of

Implementation of the Telecommunications Act of 1996:

Accounting Safeguards Under the Telecommunications Act of 1996

CC Docket No. 96-150

REPLY COMMENTS OF PACIFIC TELESIS GROUP

MARLIN D. ARD
LUCILLE M. MATES

140 New Montgomery Street, Rm. 1526
San Francisco, California 94105
(415) 542-7654

MARGARET E. GARBER

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-6472

Attorneys for PACIFIC TELESIS GROUP

Date: September 10, 1996

TABLE OF CONTENTS

Page

SUMMARY ii

I. Introduction 1

II. Price Cap Protection Compels Forbearance of Accounting Safeguards 3

III. The 1996 Act Does Not Require the Commission to Develop a New System 6

IV. Discrimination is Protected Against Indirectly by Accounting Safeguards and Directly by Sections of the 1996 Act 8

V. Cost Allocation Rules Will Satisfy the Requirements of the 1996 Act 9

VI. Affiliate Transactions Rules Are Sound and Effective 12

VII. Specific Services or Issues 16

VIII. Conclusion 23

SUMMARY

The 1996 Telecommunications Act charges the Commission with prescribing, approving or designating accounting principles or requirements for a BOC in its dealings with its separate affiliates required for competitive activities by §272(a). The 1996 Act does not, however, direct the Commission to adopt specific requirements. Thus, the Commission can and should exercise its authority to implement Congress's intent in ways that "protect against improper cost allocation, while allowing the BOCs and other incumbent local exchange carriers to realize their reasonable competitive advantages and ensuring that the consumers of those carrier's regulated telecommunications services are able to share in the carriers' economies of scope." *NPRM*, para. 7. The existing accounting safeguards will satisfy the statutory requirements. The modifications proposed by the *NPRM* are not necessary.

However, because of the protection against cross-subsidy provided by price cap regulation, particularly when carriers choose the no sharing option, the Commission should forebear from requiring price cap carriers to comply with the accounting safeguards. Commenters have not provided any reasonable arguments that explain why the Commission should continue to apply accounting safeguards to price cap carriers.

The Commission need not change the current accounting safeguards to protect against discrimination. The current affiliate transaction rules and numerous provisions of the 1996 Act provide both direct and indirect protection.

Cataclysmic changes to the current cost allocation rules should be rejected. Several commenters suggest fundamental revisions, such as discarding cost-causation in favor of

"benefit" as the basis for allocation, and adopting the affiliate transactions rules to separate costs of integrated nonregulated operations instead of the cost allocation rules. Commenters, however, fail to explain why the suggested changes, which would require significant resources to implement, would be an improvement. The Commission acknowledges that the current system has worked well and generally has been effective in deterring improper allocations of costs and unlawful discrimination.

Similarly, for the new services BOCs are permitted to provide pursuant to the 1996 Act, the Commission should adopt its current affiliate transactions rules without the proposed modifications. The record evidence clearly shows that implementing the proposal to apply the asset transfer rules to service transactions would be very impractical. The administrative costs of undertaking fair market value studies for all services could result in affiliates foregoing service transactions with the BOC and commensurately reducing the economies of scope enjoyed by ratepayers.

Commenters strongly disagree with the Commission's proposal to eliminate the prevailing company price valuation method. Instead of eliminating prevailing price, which can be useful in appropriate circumstances, the Commission should decide when prevailing price would be a reasonable valuation tool.

Many of the recommendations by commenters are unnecessary. The Commission should reject:

- treating regulated incidental integrated interLATA services as nonregulated. The current process will cause interLATA service costs to flow into the Part 69 Interexchange price cap basket and thus be segregated from other regulated costs.

- requiring interLATA affiliates to file their own CAMs. All interactions with BOCs are currently monitored through the BOCs' CAMs.

- requiring affiliates to adopt Part 32 USOA accounts. Part 32 is geared to the needs of telecommunications regulators and is not needed for nonregulated companies.

- expanding the audit requirements beyond the requirements of the 1996 Act. Congress did not intend the fishing expedition that commenters propose.

- expanding the detail that BOCs must provide in their CAMs. The Commission should maintain its requirements which balance the public interest in disclosure and the BOCs' right to privacy and protection of their competitive information.

- mandating that BOCs must impute the highest tariffed rate for facilities or services that it provides itself. The rate applicable under the tariff must be imputed.

- requiring BOCs to remove all costs of telemessaging from its Part 32 accounts. This directly contradicts Part 32 rules and the *Joint Cost Order*.

- treating the BOC's and its regulated merger partner's areas as "in region" prior to the merger becoming final. Part 64 rules apply to the BOC and its regulated merger partner during the pendency of the merger.

- requiring affiliates to estimate anticipated costs of affiliate transactions. This recommendation merely increases the administrative/regulatory costs of affiliates with no countervailing benefit -- except to competitors, who will not have such costs.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996	CC Docket No. 96-150

REPLY COMMENTS OF PACIFIC TELESIS GROUP

Pacific Telesis Group ("PTG") hereby respectfully submits its reply to comments in the above-captioned proceeding.[1]

I. *Introduction*

The Commission tentatively concludes that the accounting safeguard rules effectively protect against cross subsidy by BOCs and their affiliates engaged in activities pursuant to the 1996 Telecommunications Act.[2] We agree, as do other RBOCs. Competitors, on the other hand, favor increasing the requirements. That is not surprising. They have every incentive to lobby for increasing the regulatory burden on the new 1996 Act services.

---

[1] *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Notice of Proposed Rulemaking*, FCC 96-309, released July 18, 1996 ("*NPRM*").

[2] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act").

Competitors raise many issues that are completely irrelevant to accounting safeguards--perhaps to obfuscate the simple conclusion that the current rules meet the 1996 Act's requirements. They also use this accounting safeguard proceeding as a platform to espouse positions on many issues that were (or should have been) raised in other dockets.[3] The Commission should disregard these irrelevant objections and comments.

Competitors also exaggerate the need for safeguards by ignoring requirements already in place: MCI asks the Commission to require the BOCs to record affiliate transactions at tariffed rates if they are provided pursuant to tariff. MCI, pp. 19-29. We are already required to do so under current Part 64 rules. Similarly, WorldCom directs the Commission to apply the

---

[3] The long list of irrelevant issues raised includes, for example:

- AT&T argues for dominant treatment of interexchange affiliates (a topic for CC Dkt. 96-149). AT&T, p. 9-11.
- MCI, WorldCom, and AT&T assert that interLATA affiliates must reflect access charges in their end-user rates. MCI, pp. 25-28; WorldCom, pp. 15-16; AT&T, p. 9-11.
- ATSI (p. 7) discusses unbundling (a topic for CC Dkt. 96-98) and alternative dispute resolution (CC Dkt. 96-149). ATSI, p. 9.
- APCC raises a host of issues that are pending in CC Dkt. 96-128 (Pay Telephone Reclassification and Compensation).
- CompTel discusses out-of-region service status, urges its own definition of incidental interLATA services, and argues for greater structural separations for interLATA services than required by Congress -- all topics for CC Dkt. 96-149. CompTel, pp. 8-18.
- MCI, CompTel, WorldCom and TRA argue against joint marketing (a topic for CC Dkt. 96-149). MCI, pp. 33-35; CompTel, p. 15; WorldCom, p. 30; TRA, 21-22.
- WorldCom discusses the enforcement measures for noncompliance (pp. 16-17), and advocates limiting the activities of entities, i.e., the RBOC's interLATA affiliate should be the basic retail entity for one-stop package offerings that include local and long distance service (pp. 21, 24), all topics raised in CC Dkt. 96-149.
- The filing by the Economic Strategy Institute, while captioned for this docket, clearly is misfiled. The discussion of price squeezes in the context of international delivery of communications services is not relevant to the accounting safeguards.

same cost allocation requirements to the RBOCs' incidental interLATA services that are applied to their other interLATA services. Although there are few existing BOC interLATA services, they would all be subject to the same cost allocation rules.

Statements about the cost allocation manual (CAM) are often in error. APCC claims that CAMs do not identify BOCs' affiliate transactions with nonregulated operations, that the CAM does not describe the businesses of affiliates, and that the specific transfer methodology employed for specific transactions is not provided. APCC, pp. 13-14. MCI requests that BOCs provide a quarterly listing of affiliate transactions with a summary. MCI, pp. 29-33. BOCs currently provide this information in their CAMs pursuant to the Commission's requirements.

In the following pages, we respond to the few relevant issues raised by commenters and provide reasons why the Commission should reject the recommendations that would unnecessarily burden new competitive activities permitted by the 1996 Act.

II. *Price Cap Protection Compels Forbearance of Accounting Safeguards*

The primary protection against cross subsidy is price cap regulation. The comments fully explain how and why the Commission is correct that price cap regulation protects against cross subsidy. Commenters contesting the effectiveness of price caps as protection against cross subsidy do not explain how cross subsidy is possible for a price cap carrier who elects a no sharing option. Instead, they offer conclusory statements that accounting safeguards are needed despite price caps (MCI, p. 39; NYDPS, 10-11) or they toss about a reference or two to the productivity factor. MCI, p. 5. These comments cannot be taken seriously in the absence of reasoned explanation. And, none are forthcoming because there are no convincing arguments.

Sprint's argument that the availability of exogenous treatment is an incentive for cost misallocation is unconvincing as a reason to retain cost allocation rules for price cap carriers. Sprint, p. 17. Whether carriers are permitted exogenous treatment is entirely at the discretion of the Commission. Since initially establishing exogenous treatment, the Commission has added more conditions that must be met before it will grant exogenous treatment. Moreover, the vast majority of exogenous adjustments have *decreased* regulated rates. In addition, periodic reviews to evaluate profit levels will be available whether or not carriers are required to follow the accounting safeguards rules. Sprint, p. 18.

In addition to a nonsensical argument about pure price cap regulated companies being able to maintain artificially high prices for essential services needed by competitors, CompTel claims that "under the pricing methodologies adopted in the Interconnection Order, an ILEC has an incentive to shift costs to the provision of local exchange elements in order to maximize the TELRIC-based price that it may charge." CompTel says that the carrier could do this by increasing the joint and common costs associated with an element. CompTel, pp. 6-7.

CompTel's argument is meritless. First, there is no linkage between Part 64 cost allocation rules which are based on total company costs--a "tops down" methodology--and TELRIC, based on forward looking network element costs--a "bottoms up" approach. Second, CompTel ignores the fact that the Interconnection Order[4] describes both the allocation standard

---

[4] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* CC Dkt. No. 96-98, *First Report and Order*, FCC 96-325 (August 8, 1996) ("*Interconnection Order*"), paras. 694 -698.

required by the Commission--reasonable allocation--and specific examples of what would and would not meet that standard:[5]

> We conclude that forward looking-common costs shall be allocated among elements and services in a reasonable manner, consistent with the pro-competitive goals of the 1996 Act. One reasonable allocation method would be to allocate common costs using a fixed allocator, such as a percentage markup over the directly attributable forward-looking costs. We conclude that a second reasonable allocation method would allocate only a relatively small share of common costs to certain critical network elements, such as the loop and collocation, that are the most difficult for entrants to replicate promptly (i.e, bottleneck facilities). Allocation of common costs on this basis ensures that the prices of network elements that are least likely to be subject to competition are not artificially inflated by a large allocation of common costs. On the other hand, certain other allocation methods would not be reasonable. For example, we conclude that an allocation methodology that relies exclusively on allocating common costs in inverse proportion to the sensitivity of demand for various network elements and services may not be used.

The Commission adopted TELRIC, rather than TSLRIC, in large part because it would reduce the magnitude of common costs.[6] The Commission specifically rejected suggestions, like CompTel's, for inflexible allocation rules.[7] In effect, CompTel is merely trying to revisit an issue that has already been decided.

Third, competitors will see to it that regulators vigilantly scrutinize interconnection terms, including prices, to prevent any possibility that costs for local exchange

[5] *Id.*, para 696.

[6] *Id.*, para. 696.

[7] *Id.*, para. 646.

services are improperly shifted. Finally, growing competitive pressure on the price of network elements will reduce any incentives to shift costs to local exchange elements.

The Commission freely acknowledges that both the incentive and the opportunity for cross subsidy are diminished for price cap carriers that elect the no sharing option. There is no question that the Commission should implement the pro-competitive, deregulatory intent of the 1996 Act and forbear from requiring the accounting safeguard rules apply to these carriers.

III. *The 1996 Act Does Not Require the Commission to Develop a New System*

There is strong support for the Commission's tentative conclusion that the accounting safeguards should be adopted for the services provided pursuant to the 1996 Act. In addition to the RBOCs, AT&T, CompTel, and GSA agree that the rules work. AT&T, pp. 18-19; CompTel, pp. 4, 14; GSA, p. 3. With limited exception, commenters also recognize that a new system would require substantial administrative and financial resources without guarantee that a new system would better accomplish the Commission's goals. Moreover, as USTA points out, other safeguards such as reporting requirements, DOJ, SEC and FTC oversight also protect against cross subsidization, and mitigate any need for changes to the existing safeguards. USTA, p. 4.

WorldCom suggests that the Commission cannot meet its statutory duty by reaffirming the adequacy of the current rules. WorldCom, pp. 10-11. Other than that bald statement, WorldCom offers nothing to support its assertion. If Congress required the Commission to develop new accounting safeguards, it would have so directed. Congress was aware of the accounting safeguards and approved of them. It specifically referenced the Computer III rules in §276 as a minimum safeguard. But, it did not require the Commission to adopt any specific rules. Congress gave the Commission the discretion to regulate accounting matters and intended the Commission to determine the necessary safeguards. See § 276(b)(1)(c).

WorldCom is very much in error when it argues that the Commission should not consider the effect of regulation on those who are regulated. WorldCom, pp. 10-11, 14; 20-21. APCC makes a similar claim. APCC, p. 3. The Commission has broad discretion in defining the public interest, as the Court of Appeals said in *Rainbow Broadcasting v. FCC*, 949 F.2d 405, 410 (D.C. Cir. 1991).

> The Supreme Court has validated broad parameters within which the FCC may further its view of the public interest without interference from the courts. The Supreme Court has held that Congress delegated to the FCC the task of making the initial determination of how its policies may best serve the public.

The effect of regulation on the regulated entities is an appropriate factor in a public interest analysis in that the cost of regulation must be considered relative to its benefit. The Commission would be derelict if it failed to do so, especially in this case where regulations can have the effect of either stimulating or quashing real competition.

The Commission recognizes this. As is noted in its *NPRM*, the Commission said that it would "continue to seek to minimize the burden our rules impose upon those subject to them...", and more specifically, "We note that those urging that we adopt more detailed accounting safeguards than those in our current rules or those specifically mandated by the 1996 Act bear a heavy burden of persuading us to adopt such safeguards." *NPRM*, para. 12.

Moreover, the effect of regulation on regulated entities was very much a part of Congress's recent deliberation. Title IV of the 1996 Act is devoted to regulatory reform. There, the Congress directs the Commission to review all regulation every two years and to repeal or modify regulation that is no longer in the public interest; to forbear from regulating what it determines is unnecessary to ensure just and reasonable, and nondiscriminatory charges or practices; and to eliminate unnecessary Commission regulations and functions. These directives require the Commission to consider the effects of Commission actions on those subject to the regulations.

IV. *Discrimination is Protected Against Indirectly by Accounting Safeguards and Directly by Sections of the 1996 Act*

The *NPRM* proposes nondiscrimination as a goal for the accounting safeguard rules. *NPRM*, para. 6. The affiliate transactions rules indirectly protect against discrimination in that affiliates must be charged or charge tariffed prices or prevailing company price, if appropriate. In those instances, tariffed or prevailing company price would also be charged to nonaffiliates. Nondiscrimination, however, is directly safeguarded by provisions of the 1996 Act, and by §202 of the Communications Act. For example, §251 includes nondiscrimination provisions relating to interconnection for competing carriers. Section 272(b)(5) generally prohibits discrimination in that transactions with affiliates must be on an arm's length basis. Section 272(e) sets out specific provisions that ensure nondiscriminatory treatment. Section 260(a) is directed specifically to telemessaging services. Incidental interLATA services are protected pursuant to §271(h). Specific protections for manufacturing competitors are sprinkled throughout §273. Section 274(d) requires the provision of basic telephone service at just and reasonable rates no higher on a per unit basis than charged to the separate electronic publishing affiliate. Section 275(b) is a nondiscrimination provision relating to ILECs engaged in alarm monitoring. Payphone service discrimination is expressly prohibited in §276(a)(2). With these explicit prohibitions and the affiliate transactions accounting safeguards, nothing further is required to protect again discrimination.

V. *Cost Allocation Rules Will Satisfy the Requirements of the 1996 Act*

Most commenters agree with the Commission's tentative conclusion that the cost allocation rules have been effective in deterring cross subsidy. As the Commission recognized, "the system of existing safeguards have worked reasonably well and generally have been effective...in deterring the improper allocation of costs and unlawful discrimination."[8]

Consequently, the Commission should reject several suggestions of systemic change. Current Part 64 rules provide for a system of direct attribution based on cost causation. APCC proposes that the Commission change the allocation basis to "relative benefit received" -- not cost causation -- in order to reduce regulated costs. APCC, pp. 17-18. APCC believes that using benefit as an allocator would reduce the disproportionate amount of allocation to regulated carriers that occurs now because of the relative sizes of regulated carriers and nonregulated affiliates. APCC argues for a fundamental change in the cost allocation system by proposing "benefit" as the basis for allocation. APCC also recommends that the Commission should require the use of a factor which gives 50% weight to the general and marketing allocation factors as they exist today, and 50% weight to a factor which allocated 50% of the cost to nonregulated operations and affiliates and 50% to regulated operations. APCC, p. 18. APCC's

---

[8] *Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as amended; and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area,* CC Docket No. 96-149, *Notice of Proposed Rulemaking,* FCC 96-308, Released July 18, 1996 ("*Non-Accounting Safeguards NPRM*"), para. 146.

perspective is based on sheer speculation, unsupported by any evidence. For example, APCC suggests that more of the costs of a CEO would be allocated to a nonregulated operation if allocation were based on benefit. APCC reasons that a CEO may spend a disproportionate share of time and attention on nonregulated operations. On the other hand, one could just as easily argue that a CEO would spend more time directing the largest revenue producer (the regulated operation) and not a smaller nonregulated startup. APCC's second example, that generic advertising provides greater proportional benefit to nonregulated operations, is also purely speculative. Generic advertising far favors regulated operations given the intense competition for local exchange service. These two problems illustrate the difficulty of using benefit as an allocator. Whereas cost is quantifiable, benefit is not, even if "benefit" were clearly defined. APCC fails to meet the "heavy burden" required by the Commission when suggesting changes to the current system. *NPRM*, para. 12. In the absence of significant evidence that the current system is not accomplishing its objectives, the Commission is right in requiring very persuasive reasons before it makes any wholesale change to the cost allocation system. Moreover, the extensive cost to redesign systems and train employees on new accounting safeguard rules demands that there be some assurance that the new system will better accomplish the goals of the 1996 Act than the existing system.

CompTel encourages the Commission to apply the affiliate transactions rules to integrated operations. CompTel, p.19. In essence, CompTel requests the Commission to jettison the cost allocation system for the 1996 Act's integrated operations. While the Commission made clear that affiliate transaction rules apply to transfers between regulated and nonregulated accounts as well as between regulated and nonregulated affiliates,[9] there is no suggestion in the 1996 Act that the Commission should override its effective cost allocation system. CompTel's unsupported suggestion also fails to meet the "heavy burden of proof" required of parties that suggest such a cataclysmic change to the present effective system.

APCC also advocates applying the affiliate transactions rule to integrated payphone operations. APCC, pp. 8-10. APCC focuses on a provision in the Commission's rules that requires the application of affiliate rules to an integrated operation that is accounted for on a separate set of books.[10] Only nonregulated operations which do not involve the joint or common use of assets and resources can be accounted for on separate books. APCC stretches the Commission's rules to argue that assets and resources should not be shared; if shared, they should be minimal, and *ergo,* the affiliate transactions rules should apply. But the rules do not refer to "minimal" joint and common costs. If there are any joint and common costs, 32.23(c) directs carriers to account for regulated and nonregulated products and services on the carrier's books. The Commission should disregard APCC's misconceived notions that would eliminate the cost allocation methodology for integrated payphone operations.

---

[9] *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities,* 2 FCC Rcd 1298 (1987) ("*Joint Cost Order*"), recon., 2 FCC Rcd 6283, para. 121, (1987) ("*Joint Cost Reconsideration Order*"), further recon., 3 FCC Rcd 6701 (1988) ("*Joint Cost Further Reconsideration Order*"), aff'd *sub. nom. Southwestern Bell Corp. v. FCC* 896 F.2d 1378 (D.C. Cir. 1990)

[10] 47 C.F.R. §32.23(b) and (c).

VI. *Affiliate Transactions Rules Are Sound and Effective*

In general, commenters agree with the Commission's tentative conclusion that the affiliate transactions rules effectively protect against cross subsidy. However, several meritless proposals should be rejected. First, suggestions that the transfer of intangibles, such as the goodwill in a BOC's name and the value of training BOC personnel, are assets that must be subject to affiliate transactions rules are wrong. APCC, pp. 18-21; AT&T, p. 14. The Commission previously rejected that notion. The accounting safeguards are designed to ensure that nonregulated *costs* are not passed on to regulated activities, resulting in cross subsidy. Intangible assets are not reflected on a carrier's books, and are not therefore costs that are subject to the Part 64 rules. The Commission rejected the allocation of intangible benefits as outside the scope of the *Joint Cost* proceeding.[11] Explaining intangible benefits in the context of the transfer of trained personnel, it rejected the application of the transfer rules to personnel for two reasons: first, because training is a sunk cost that is not routinely reimbursed when an employee is transferred; second, the *value* of training, a "cost-less" intangible, was beyond the scope of the accounting safeguards.[12]

The Commission reiterated that position in response to a claim that Ameritech should allocate the value of its name. The Commission explained:

> In the Joint Cost Order, the Commission found that intangible benefits and the allocation of those benefits was beyond the scope of this proceeding. [Citation omitted.] Although the Joint Cost Order provides a mechanism for allocating all of a carrier's costs

[11] *Joint Cost Order*, para. 41.

[12] *Joint Cost Recon. Order,* para. 133, n. 204.

> between regulated and nonregulated activities, intangible benefits, such as the Bell name, are not costs. No costs associated with the Bell name have ever appeared on the Ameritech's books.[13]

The Commission's logic continues to be sound today. Suggestions that would subject intangibles to the Part 64 process must be rejected.

The response to the Commission's proposal to apply the asset transfer rules to service transactions was clear. Carriers that would be subject to the proposal leave no doubt that the Commission's proposal would be very impractical to implement. On the other hand, commenters that urge the Commission to adopt the fully distributed cost/fair market value (FDC/FMV) comparison for services do not provide any support to overcome the well-chronicled disadvantages. If, nonetheless, the Commission adopts this proposal, at minimum it should forbear from applying the FDC/FMV standard to price cap carriers that elect the no sharing option. We have clearly shown that for these price cap carriers, costs cannot affect rates. Thus, adopting the FDC/FMV standard for price cap carriers will only result in significantly increased administrative costs. If administrative costs become too burdensome, BOCs and affiliates will be discouraged from continuing their service transactions and that will affect the economies of scope enjoyed by ratepayers. As Professor Hausman explains, if the Commission adopts excessively stringent regulatory restrictions on the BOCs, it is likely to

[13] *Ameritech Operating Companies Permanent Cost Allocation Manual*, 3 FCC Rcd 433(1988), para. 40.

decrease BOCs' innovation to create economic inefficiency, and create higher prices for consumers.[14]

Unlike comments on applying the FDC/FMV standard to service transactions, there was strong support for the Commission to retain the prevailing company price methodology.[15] The oppositions to the use of prevailing company price are not persuasive. CompTel opposes this method as "rife with uncontrollable discretion." CompTel is wrong. As AT&T aptly points out, "the fact that such prices are determined in a market does provide some external discipline on the BOCs' and their affiliates' pricing methods." AT&T, p. 15. The Commission's reasons for eliminating prevailing company price for transactions between a BOC and its §272 affiliates did not include concerns about manipulation for good reason. Prevailing company price can only be used where there are verifiable transactions between the carrier and independent parties. The *Joint Cost Recon. Order*[16] made that clear:

> By adopting the price list as an alternative methodology for determining fair market value, we intended to provide that a prevailing price could be used instead of a tariff price. We did not intend to require that the price be necessarily available in a "price list," so long as there are sales records from which to verify that a generally available price was charged, asset value need not be recorded in a formal price list.

---

[14] *Non-Accounting Safeguards NPRM,* USTA Reply Comments, Reply Statement of Jerry A. Hausman, para. 2.

[15] The prevailing price method describes the use of the price at which a company offers an asset or service to the general public to establish the value of the affiliate transaction.

[16] *Joint Cost Recon. Order*, para. 120.

MCI says that the Commission should eliminate prevailing company price because of the difficulties in determining whether a substantial portion of an affiliate's production is being provided to a third party.[17] MCI would have the Commission reject the prevailing company price method rather than resolve the issue of what constitutes substantial independent sale. As we said in our Comments in this proceeding, the prevailing company price methodology can be a useful option if the Commission resolves the outstanding issues of the Affiliate Transactions Notice proceeding related to what constitutes prevailing price.

APCC suggests retaining prevailing *market* price as the maximum price when the affiliate provides services to the carrier. APCC misunderstands prevailing company price as "prevailing market rate". First, APCC claims that the difference in business costs when dealing with one's own affiliate is not built into the price if it is based on prevailing market rate. That, APPC claims, would overstate the true cost of providing a product to the BOC and permit the nonregulated affiliate to receive added revenue which, in turn, would permit it to lower prices of other competitive assets and services to the detriment of fair competition. APCC, p. 27. The answer to APCC is simple. The notion that selling to an affiliate is less costly is unproven, especially when one affiliate is regulated. As Sprint points out, "in a competitive market with a variety of suppliers offering a plethora of price and service options, an entity has to work just as hard to sell to its affiliates as it does to non-affiliates." Sprint, p. 12. Moreover, the administrative costs of complying with the affiliate transactions rules eliminate any reduction in

---

[17] MCI, nonetheless, suggests a solution that might resolve the difficulty. We continue to disagree with MCI's recommendation of a 75% threshold. *Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and their Nonregulated Affiliates*, 8 FCC Rcd 8071 (1993).

transactional costs, if there were any. Moreover, APCC's recommendation would eliminate any incentive for an affiliate to do business with a BOC and would deprive ratepayers of any benefit from economies of scope that will be passed on through the productivity factor.

The prevailing company price method will not be useful in all transactions. But when it is appropriate, the BOCs should be able to use it. The Commission should not replace this simple, useful method with costly fair market studies. The Commission should decide the issue of what constitutes a prevailing price raised in the Affiliate Transactions Notice. Then, it can rely on its right to audit and its ability to require a carrier to justify its use of the prevailing company price method.

VII. *Specific Services or Issues*

a. Integrated interLATA services -- Some commenters supported the Commission's proposal to treat integrated interLATA services as nonregulated activities. WorldCom, pp. 13-15; CompTel, p. 10; AT&T, pp. 18-19. MCI argues for even finer disaggregation so that the Commission (and MCI) can separately monitor the costs allocated to interLATA services. MCI p. 13-15. TRA argues for treating all currently regulated integrated BOC activities outside the scope of local exchange and exchange access services as nonregulated. TRA, pp. 25-26. These commenters believe that misallocation of the costs of these services will be more readily detected by this treatment. In our Comments, we recommended that the current treatment of interexchange costs would be effective to segregate integrated incidental interexchange services from regulated costs of local exchange and exchange access services.[18] The alternatives proposed by the Commission and endorsed by these few commenters unnecessarily complicate the regulation of incidental interLATA services and should be rejected.

b. InterLATA affiliate and other nonBOC affiliates -- Several commenters' suggestions would do nothing more than add inappropriate, anticompetitive burdens to affiliates providing new services pursuant to the 1996 Act. For example, MCI proposes a monitoring regime to oversee the interLATA affiliate's relationship with other regulated and nonregulated affiliates. MCI also suggests that interLATA affiliates be required to file their own CAMs with the Commission. MCI, pp. 33-35. These suggestions are unnecessary and should be rejected: First, the Commission already can monitor any interaction between the interLATA services affiliate and a regulated entity without additional rules because existing rules require regulated LECs to report all transactions with nonregulated affiliates.[19] Second, there is no need to monitor the relationship between the interLATA services affiliate and nonregulated affiliates because neither affiliate has the incentive to disadvantage its own competitive products by cross subsidizing the other entity.

The Commission should also reject MCI recommendation that BOCs be required to reallocate any embedded costs attributable to the provision of interLATA services. MCI, p. 35. That is unnecessary. If a BOC uses any embedded facilities to provide interLATA services to its interLATA affiliate, the transaction will be subject to the affiliate transaction rules and provided pursuant to tariff, if applicable.

---

[18] *Comments of Pacific Telesis Group*, August 26, 1996, p. 11.

[19] The Commission has tentatively concluded that an interLATA services affiliate will be deemed nonregulated for accounting purposes.

c. Part 32 Books -- Several commenters urge that affiliates should maintain their books using Part 32, the Uniform System of Accounts ("USOA"). MCI, pp. 17-19 (manufacturing and interLATA information services affiliates and interLATA telecommunications affiliates). WorldCom would require all separate affiliates, presumably even those providing nonregulated activities, to use the USOA. WorldCom, p. 22. This requirement is unnecessary and would be detrimental to nonregulated companies. It makes absolutely no sense to require nonregulated affiliates to use a regulated accounting system. The USOA is meant to provide accounting and reporting instructions for regulated telecommunications companies and is geared to the perceived needs of telecommunications regulators. Part 32 requires a wealth of detail concerning telecommunications plant investment and expenses, and revenues generated by telecommunications products. That information should not be required from nonregulated companies. In addition, Part 32 has a number of provisions which should not apply to nonregulated companies, such as contingent liability booking rules and property record requirements. The Commission should allow nonregulated companies the freedom to develop accounting systems that meet their internal management needs as well as the informational needs of external stakeholders. The Commission has been successful in monitoring affiliate transactions without requiring that nonregulated affiliates use the USOA.

AT&T maintains that even if interLATA services affiliates are declared nondominant, they should be required to maintain books according to Part 32. AT&T, p. 12. If the Commission chooses to do so, it must apply its accounting requirements uniformly to all carriers similarly classified. To do otherwise would create a regulatory imbalance which will translate into additional costs for the affiliates' competitive products, a burden not shared by its competitors.

d. Audits -- Some commenters urge the Commission to exceed the statutory requirements of the 1996 Act. AT&T suggests annual audits. AT&T, pp. 17-18. MCI suggests that the §272(d) audit should supplement the regular CAM audit. MCI, p. 37. NYDPS suggests that the auditor be chosen jointly by the BOC, the Commission, and the state. NYPDS, pp. 9-10. CompTel suggests that the first audit take place six months after interLATA operations begins. CompTel also urges that the BOC pay for the audit and include the payment among the BOC's intraLATA costs.[20] CompTel, p. 17. NARUC outdoes them all by recommending audit procedures and guidelines that introduce a high level of intrusion into the independent audit process. NARUC, Appendix C.

The Commission should reject all of these recommendations. Instead, it should adopt YPPA's position: "The Commission should impose requirements which are no more onerous than necessary to prove that the affiliate...has not violated the affiliate transactions rules...." YPPA, pp. 3-4. YPPA is exactly correct in that the reviews should not become massive fishing expeditions, taking up enormous amounts of time, energy and money. That is not what Congress intended. If that were so, Congress would have specified the kinds of details recommended by NARUC as well as more frequent audits for the §272 activities. It did not do so and it did not direct the Commission to do so. The Commission should *implement*, not extend, Congress's intent.

e. CAM -- Commenters call for greater detail in the CAMs. Some would require ridiculous amounts of information. APCC has a laundry list of data it wants included in the

[20] CompTel, however, fails to explain why audit costs for an interLATA affiliate should be treated as an intraLATA costs.